INTERNATIONAL SUPERVISION OVER FOREIGN INVESTMENTS

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The significant fact for the discussion of any phase of international economic relations, even a minor phase like the one now under consideration, is that the jurisdiction of the trading world of today is broader than the jurisdiction of any of the governments whose citizens appear as traders on the world's market. The attempt to analyze this situation and to disclose the imputations which it holds, has given rise to two schools of economic thinking. On the one hand, the industrial interests of individuals, whether engaged in domestic or foreign trade, are conceived to be the same, and, consequently, national boundaries are ignored in the study of economic relations. All phases of foreign trade, foreign credit, and foreign investments are conceived to be satisfactorily adjusted by the doctrine of comparative cost. On the other hand, it is contended that trade relations which extend beyond the boundaries of a particular state constitute an economy of a different sort from that adjusted to the requirements of intra-national trading. The instinct of profit seeking, acting under the restraints of the institution of private property, is not accepted as a competent agency of industrial control, the result being that government is encouraged to assume definite economic responsibilities. This is the school that takes the name of National Economy. Its basic doctrine is that the state as an organic unity must entertain industrial ends of its own distinct from those of its citizens, and that these ends are supreme even in the economic field.

In one particular, these two schools of economic thinkers, the National school and the Classical school, agree. Neither admits the existence of a distinctive world economy. For National economists, when world commercial relations "break into the national economic sphere," the situation engendered is "but a detail of the extended policy of national economy."[1] There is here no conception of a world economic problem. For the Classical economist, world trade is in no sense different from trade between citizens of the same state, and the business of government is limited to the protection of contracts and the enforcement of obligations.

A second generalization respecting foreign trade relations is equally

[1] Grunzel, *Economie Protectionism.*

significant. The doctrines of these two schools of economists are reflected in the diplomacy of the respective countries where they find acceptance. The one assumes to guide and to foster the commercial interests of its nationals by an aggressive industrial program; the other, while it assumes to permit its nationals to trade where they please, under any arrangements they can make and on their own responsibility, is forced into an aggressive policy in order to protect citizens in their rights, according to the home definition of such rights. Thus it comes about that aggression in the name of defense is characteristic of the governments of first-class powers, whether the policy of such governments be adjusted to the principles of national or of classical economists. There is no recognized or established standard of conduct for the world market; on the contrary, there are as many codes of business morals and legal rules as there are different nationals trading on that market. It is this fact that makes clear the point of view from which a proposal to establish international supervision over foreign investments should be approached. It raises a practical problem in world economy.

The industrial and political character of world economy may be traced to an added fact respecting it. Not only is the trading world of today made up of independent political units, but each of these units stands on a different rung of the ladder of economic attainment. Some have already exploited their national resources, at least up to the present limit of applied science; others have resources as yet only partially exploited. Some have ample funds of labor skilled in industry or drilled for organization; others have ample workers so far as numbers are concerned, but these workers are untrained for the organization of effective production. The factor of capital, also, which, as here used, covers intelligence, machinery, and waiting power, exists for some peoples in abundance; for others it is a scarce and a coveted factor. Even ability for management and guidance is not equally diffused among the nations that appear as traders on the world market. The earth is full of unoccupied commercial opportunities for those who have the vision to see and the power to take.

Under such conditions, it quickly becomes the dominant commercial purpose of those peoples who stand in the fore rank of economic attainment to exploit the industrial opportunities of backward peoples. Not only does this purpose respond to the commercial instinct because of the profit to be gained, but it appeals to the imagination of forceful intellects as a contribution to the economic building, or it may be re-building, of the world. Whether or not the world needs to be

rebuilt, I do not undertake to say; but the master fact of the present situation is that peoples who possess the power for aggression have decreed that the world must be reorganized to meet the requirements of machine production and of big business control. This being the case, the problem for a world-economy is to analyze and to measure the relative equities involved in this transformation, and the problem for a world-diplomacy is to standardize the conditions under which the industrial rebuilding of the world should take place. It is because these problems have not been solved that Western peoples for centuries have lived in a constant state of potential warfare.

It would be an error, however, to hold commerce responsible for the dangers inherent in this situation. There is nothing sinister in foreign trade nor in the motive which leads advanced peoples to press their guidance and their capital on backward states; nor is there any reason in the industrial situation considered by itself why sinister results should follow the working out of this motive. If the rivalry of first-class powers for the control of foreign markets, whether for the sale of goods or the investment of capital, has proven itself a menace to the peace of the world (and that such is the case, no one will care to deny), the explanation must be sought in the arrested development of political relations rather than in the under-development of industrial conditions. The integration of political control has not kept pace territorially with the expansion of commercial interests. An opportunity is thus afforded for the assumption of national sovereignty and the exercise of national authority within a domain occupied by international relations. The attitude of mind or of national sentiment thus engendered, if entertained by two or more first class powers, must lead to confusion, misunderstandings, and conflicts. In this fact do we find the explanation of those sinister results which, from the sixteenth century to the present time, have accompanied the industrial and commercial development of the world. It is this fact that makes some form of limited international control over foreign investments and foreign loans the vital, outstanding problem of constructive diplomacy. The proposal to establish international supervision over foreign investments is an important although a minor phase of that comprehensive program of international organization which has for its aim the maintenance of commercial peace. It has the same historic background, and carries with it the same diplomatic imputations. Such, at least, is the interest I find in a discussion of foreign loans and foreign investments.

The diplomatic significance of international investments depends on

the conditions that surround them rather than on their amount. The most simple of the conditions under which international borrowing is carried on arises when the two nations concerned are of the same industrial and political standing and rely on the same legal principles and practices for the interpretation of obligations and the enforcement of contracts. The relative standing of England and the United States may be cited in illustration. These countries accept the same theories respecting the origin and use of capital; they entertain the same ideas respecting business organization and management; their programs for government supervision over business practices are very much alike; but of more importance is the fact that these countries follow the same rules in the organization and control of their courts. If to these facts is added the further fact that the potential military and naval strength of the one country is about on a par with that of the other, a situation obtains in which investments and loans as between these two countries is a matter of diplomatic indifference. The creditor relies for the security of his investments not on the diplomatic pressure of his home government, but on the orderly working of the courts of the debtor country. Under such conditions, foreign investments and foreign loans, like foreign trade, raise no international problems. They are in all essential particulars like domestic investments, domestic loans, and domestic trade. Any international understanding which has for its aim the standardization of industrial procedure so far as foreign investments and loans are concerned, may drop these nations from the list of nations to be considered.

International embarrassments which arise on account of foreign investments and loans are traceable primarily to the political and industrial conditions of backward peoples. When the debtor nation is industrially undeveloped, or under-developed, as compared with the creditor nation; when the machinery on which the debtor nation relies for the enforcement of business agreements is not familiar to the citizens of the creditor nation; when the mingling of democratic forms with autocratic practices makes the foreign loan a risky investment; but especially when the debtor nation is politically weak, the governments of creditor nations have always responded to appeals from their nationals for some form of peculiar protection. This, at least, has been the practice of capital-building and over-sea trading nations since the sixteenth century, and it is largely upon this fact that the need of commercial diplomacy for the standardization of commercial practices rests. It is with this kind of international investments that the constructive diplomacy of the future must concern itself.

We are, perhaps, not aware of the extent to which the principle of exterritoriality has been carried by the powerful nations in their economic rebuilding of the world. Exterritorality, in its technical sense, means the substitution of the court procedure of a creditor country for the business practices of the debtor country. When one takes a broad view of the subject, however, there are many expedients outside the formal practices of the courts to which the investors of creditor nations resort in order to insure the safety of their investments. Diplomatic pressure may be brought to bear and that in a way that no ambassador or consul would think of doing, were he dealing with the subjects of a first-class power. The revenue machinery of a debtor nation may be taken over by agents of the creditor nation, and accredited representatives of the investors may be placed in charge of the industries created, even though the investors have no title in the property. Most of the railways of China, for example, are the property of the Republic of China, but they are operated by foreigners and their revenues are paid to foreign banks.

Arrangements of this sort, although they encroach upon the independent, responsible action of weak debtor states, may perhaps be justified when regarded as a step in the political and industrial transformation of the world. That point is not raised. The situation has been described in order to make clear the fact that an application of the spirit of exterritoriality is more comprehensive than the technical definition supplied by international law. It comprises all those avenues of influence by which the authority of one nation permeates and controls the business and political life of another nation.

Not only does this situation endanger the interests of weak peoples, but it is the occasion of constant irritation between first-class powers. Were one capital-lending country only in a position to exercise exterritorial influence, it might not perhaps be abused. There would at least be no competitive temptation for its abuse; but when the governments of England, France, Germany, Japan, and the United States, to say nothing of others that might be mentioned, encourage their respective nationals to make investments in countries like China, Persia, or some of the republics of South America, by offers of peculiar protection, the belligerent tendencies of such a policy may be readily understood. Each lending nation becomes jealous of the investments made by the others, and the atmosphere of intrigue and suspicion thus engendered is conducive neither to the normal working of economic laws which ought to control all investments or loans, nor to the good understanding which makes for peace. The diplomatic representatives of capital-

lending nations at the courts of weak powers are in a constant state of potential warfare. It is to this situation that constructive diplomacy should direct its attention. The exercise by first-class powers of exterritorial influence, if in the present undeveloped condition of certain states it must exist, should be exercised on the basis of a carefully expressed international understanding.[2] This is what is meant by the proposal of some form of international supervision over foreign investments.

The practical side of this problem may be presented by the study of some definite situation. China is selected for that purpose, and, to particularize the problem yet further, the analysis which follows is confined to Chinese railway investments. It will be quite safe to generalize from this somewhat narrow study, for the stipulation of loan agreements for investments in railways in a country like China reflects perfectly the investor's point of view. They illustrate the kinds of contracts foreign investors demand as a means of making themselves secure against what are regarded as unusual risks. They also illustrate how the debtor nation stands with regard to a property of which it holds the title but which has been built out of funds provided by foreigners. The following analysis of loan concessions will be confined to three points.

In the first place, investments in Chinese railways are commonly underwritten by banking syndicates and are made on the basis of concessions granted by the Chinese government. These concessions commonly confer upon the syndicates the exclusive right of constructing a particular railway in a particular locality. They recite the rights of the concessionaire and the liabilities incurred by the debtor government, and these rights and liabilities are accepted as the terms of a loan agreement when the syndicate offers Chinese railway securities for sale. These syndicates ought, so far as the theory of investments is concerned, to be purely an industrial organization. In fact, however, they bear a political as well as an industrial character. In this lies their danger.

In the second place, the bankers who secure funds at home for investment abroad frequently retain the right of supervisory control over the operation of the industry thus established. This is true whether an investment is on the basis of a government concession or of a private contract. The assumption by the banks of the right to supervise in-

[2] By the courtesy of the Director of the Division of History and Economics of the Carnegie Endowment for International Peace, the two foregoing pages are taken from a manuscript which is the property of the Endowment.

vestments in which their clients are interested, is more or less familiar. Under some conditions, it might not be the subject of criticism, but as carried on in countries whose local credit is not adequate to secure the capital needed for local development, this business practice assumes a sinister political aspect. In theory, it is a device to minimize risk; in many cases, however, it comes to be the means for the exercise of a pernicious exterritorial influence.

The third fact respecting these concessions is equally significant. Loan agreements of the class under consideration quite generally provide that the engineer and the accountant in charge of an industrial property built out of the proceeds of foreign monies should be appointed by the syndicate or bank which represents those who loan the money. All the Chinese government railways, for example, with a single exception, although owned by the Chinese government, are operated and financially controlled by foreigners. Foreign employees are on the pay roll of Chinese railways, but they take their instructions from foreign banks. Provisions of this sort may perhaps be necessary as props to the credit of weak debtor nations; but this kind of borrowing, when the loan is international, is sure to give rise to international complications.

The most disturbing of the minor factors involved in the stipulation for that class of foreign loans now under consideration, pertains to a provision for indirect profits as a motive for investment. It is commonly recited in Chinese railway concessions that the materials used for construction and for maintenance are to be purchased through the banks that supply the funds. It is to this fact that the standardization of foreign investments through some form of international supervision is addressed. Without such supervision, competition for investment in a country like China will prove to be the occasion not only of misunderstandings and criminal emulation on the part of investors, but the industrial rebuilding of China will be seriously embarrassed.

A review of the steps taken to meet this situation either directly or indirectly may throw some light on the requirements of a satisfactory adjustment. One of the first moves in this direction was the declaration of the doctrine of the open door for the Orient. This, however, had reference primarily to the access by all foreigners to the markets of China on equal terms and not to investments in Chinese industries. The open-door policy is based on sound economic doctrine, but it pertains to the sale of goods and not to the investment of foreign capital for production, or to services.

A second recognition of the difficulties involved in the making of

foreign loans is found in an agreement between the leading bankers of certain countries to coöperate in the matter of foreign investments. The United States was once a party to such an international understanding, which took the form of an international group of bankers, but the activities of this group were never carried sufficiently far to determine from experience of what it was capable. Shortly after the first inauguration of President Wilson, the American bankers, members of this group, obtained certain impressions as to a change in the policy of the Administration which led them to withdraw from the group. So little is known of this transaction that it would be idle to comment upon it in any authoritative manner. It is, however, known that one of the objections commonly urged against the international understanding of bankers as at that time organized was that, so far as the United States was concerned, it tended to create a monopoly in the hands of a small number of American bankers. But whatever the reason for withdrawal, it is evident from subsequent events that such a plan is inadequate. It has two significant limitations when regarded as a means to secure a satisfactory international control over foreign investments.

In the first place, this loan group was an international organization of banks, and not an international understanding of governments. This was a fatal error. In the second place, the banks carried their coöperation no farther than to loan the funds placed at their disposal. The purpose of the banks seems to have been to avoid the evils arising from competition between lenders; they made no provision for difficulties that might arise after the money had been loaned. For the solution of all questions that might arise after the loans were made they placed exclusive reliance on the tortuous machinery of diplomatic correspondence.

A third step toward the solution of the problem under consideration, so far at least as the railways of China are concerned, is found in a proposal which has recently received considerable attention on the part of the Chinese themselves. This proposal is to the effect that all creditor countries having an interest in Chinese government railways should agree to the substitution of an international commission for the national supervision which now exists under the terms of the several concessions. Such a plan has the merit of recognizing the point at issue. If realized it would at least result in the standardization of all programs and practices that have to do with the construction and operation of railways. If the functions of such a commission could be extended to cover the borrowing of foreign funds, the future

construction of railways in China would conform to some well devised plan. The present haphazard, planless procedure which results from the competition of concession hunters could no longer endure. It is my understanding that all but one of the nations interested in Chinese railways, as well as many of the leading Chinese officials, are agreed as to the advisability of an international supervisory commission of some sort, but that the representatives of Japan are not sympathetic with such a suggestion.

The advisability of a program of constructive diplomacy drawn along these general lines, cannot be questioned. China needs capital and guidance for the transformation of her industrial life. This capital and guidance she cannot secure without granting the investors the protection of some form of foreign supervision. The kind of supervision obtained under the terms of the concessions has not proven satisfactory either to the Chinese or to the foreigners, a fact due in large measure to the necessity of relying upon diplomatic procedure for the adjustment of difficulties that arise after capital has been invested. Should an international commission composed of competent men be placed in charge of the present operation and future construction of the railways in China, the rivalries and corrupt practices of concession hunters would largely cease. Investors would be secure in their investments and, proper provision for the representation of China having been made, the citizens of the Chinese Republic would be greatly benefited.

Another advantage both to the world and to China would result from such an organization for the supervision of foreign investments. A commission of this sort must live on the ground where its authority is exercised and most of the questions presented to it for solution could be answered without reference to the foreign offices of particular states. By this means, the rules of business procedure rather than that of diplomatic precedent would be brought to bear on those practical industrial questions which arise in connection with the development on Chinese soil of Chinese industries, and many questions which have within them the seeds of international misunderstandings would be settled before they became the occasion of international controversy.

It may be said that such a proposal as the one under consideration is addressed to a minor difficulty; that, at best, it is an opportunistic proposal. This doubtless is true and this, in my judgment, is its peculiar merit. While it is in harmony with the comprehensive idea of a super-state for the standardization and control of foreign commerce in all of its phases, it recognizes that possibly the time has not

yet arrived for a fruitful discussion of so comprehensive a plan. Here however, is one thing that can be done and which, if done successfully, would tend to establish rules and precedents for the extension of some form of international control over the entire field of foreign trade.

The practical problem involved is a problem in constructive diplomacy, but its interest for the economist is greater than for the statesman. For him any analysis of international trade relations brings into view commercial conditions and forces for which no adequate provision is made by the accepted doctrines of either the National or the Classical school of economists. A new field of inquiry is thus opened up for the economic theorist.